



TESTIMONY DELIVERED BY INSURANCE COMMISSIONER JOHN GARAMENDI

**“STATE COMPENSATION INSURANCE FUND VS. INSURANCE COMMISSIONER:
CAN CALIFORNIA WIN? (AND OTHER ISSUES)”**

SENATE INSURANCE COMMITTEE

STATE CAPITOL, ROOM 2040

May 20, 2004

Madame Chair, members of the committee, I welcome this opportunity to appear before you today on a matter of great importance to California, its employers, and its injured workers, namely the financial health and the efficient and effective operation of the State Compensation Insurance Fund.

Because it controls more than 50 percent of the state’s workers’ compensation market, it is essential that State Fund be established as a healthy, financially viable concern. Unfortunately, an ongoing legal dispute initiated by State Fund has seriously impeded our best faith efforts to help that organization address its current financial and management difficulties.

Indeed, this legal dispute highlights one inevitable and fundamental question of policy, which I believe can only be resolved by you and the Governor – “Should the Department of Insurance regulate the largest workers’ compensation insurer in the nation?”

My answer, which I have made clear through numerous public statements, is that since the State Fund operates as an insurance company, it should therefore be subject to the laws and regulations governing all other insurers. State Fund, however, through this lawsuit and other actions, has made it clear that its management disagrees. The people of the State of California have not benefited from this conflict. State Fund either must accept regulation by the Insurance Commissioner as does every other insurance company in the state (with the exception of those provisions in the Insurance Code providing for conservation and liquidation), or it must operate independently of Department of Insurance regulation, with my authority limited to conducting audits of its business and reporting the results to the Legislature and the Governor.

This current situation is untenable. I am expected to fulfill my responsibility under the law to regulate the State Fund, but my best efforts are met with resistance. The Fund’s management has challenged my authority to examine and direct corrective action, and has escalated its concerns about my authority to unworkable adversarial levels. Now a court is involved. The legislature, and the Governor, should clarify this situation, not the courts.

That being said, it is extremely important that you avoid mistaking this dispute for a mere turf battle between two state governmental entities. The placement of authority over State Fund’s regulation is not a turf battle. It speaks to the near and long-term economic health of our state, and in my opinion, it would be harmful to release the fund from all meaningful regulation. The prospect of a tax-exempt, unregulated State Fund would in all probability frighten away other insurers looking to do business in this already tight market.

As further evidence that this is no turf battle, red flags were raised about State Fund well before I took office. Former Commissioner Harry Low expressed concerns over its condition during his term, noting that its surplus had fallen to a level that could eventually threaten its ability to pay all future claims by injured workers. The Department's staff, under his direction, worked with management at State Fund to develop a plan that would put it back on a sound financial footing.

When I took office in January of 2003, I continued Commissioner Low's approach. State Fund appeared to benefit from our mutual efforts until May of last year, when the cooperation suddenly ceased. That break roughly coincided with reports from State Fund's outside auditor, PriceWaterhouseCoopers, as well as the Department's examiners, that State Fund's reserves were insufficient by about \$1 billion. State Fund management refused to increase its reserves as requested, fired PriceWaterhouseCoopers, and sued me.

Fortunately, during our effort to reform the workers' compensation system, we designed and proposed solutions that would immediately improve the reserve situation of all insurers, including the State Fund, through a one-time savings of about \$5 billion. Because of that reform legislation, enacted during 2003, and due to increases to its reserves that the State Fund made as of the end of last year, the fund is now in a better financial situation than it was when the controversy began. State Fund's new auditor, KPMG, has determined that its reserves are adequate. As required by law, the Department is completing its reserve review and will report to you by July 1.

However, it is important to note that while KPMG certified that State Fund's reserves are adequate, it expressed no opinion as to the appropriate level of surplus for State Fund. Reserves – the dollars an insurer expects to pay over time for claims that have already occurred - are an insurer's largest liability. Surplus, on the other hand, represents the additional assets or cushion an insurer must maintain above its reserves to meet unexpected obligations. To arrive at an insurer's surplus level, one subtracts reserves and some additional specified liabilities from the total assets of an insurer, (in State Fund's case around \$15 billion dollars). The State Fund has approximately \$12.8 billion in reserves. Thus, the State Fund's surplus level is approximately \$2.1 billion.

As we do with other insurers, we have applied Risk Based Capital analysis to the State Fund's financial situation. This is the crux of our dispute. In order for State Fund to rise above the RBC action level, its surplus, as of year-end 2003, would have had to be above \$3.6 billion. Therefore, although State Fund's reserves may not be as serious an issue now as when this debate began, we believe the Fund's surplus remains dangerously low.

It is the Department's duty under the law to monitor the surplus of insurers, to direct corrective action if needed, and to ensure that such corrective action is implemented. The fulfillment of these regulatory duties not only assures financial stability, but also that State Fund will compete with other market participants on a level playing field in terms of regulatory requirements. No other state or regulatory entity performs this important task, which we are given under the state's Risk Based Capital statute. So again, it is up to you and the Governor to decide if you want the Department to perform this activity, or leave State Fund unregulated.

In addition, State Fund has suffered from a number of management and operational problems that must be addressed. Early last year, I urged the management of State Fund to hire a consultant to help it deal with those issues. The State Fund chose IBM Consulting, which issued a report in July, 2003 recommending remedial action in eight operational areas. IBM conservatively estimated implementation of these actions could save State Fund as much as \$294 million annually. For example, IBM noted that 5% of workers' compensation claims account for 95% of State Fund's losses, yet State Fund has no system in place to identify those claims on a timely basis to ensure that they are properly handled. IBM reported that "State Fund's current operating model impairs its ability to curb high cost claims."

IBM also noted that State Fund may be missing opportunities in medical provider direction, fraud detection, denials of compensability, avoidance of fines, subrogation, legal cost avoidance and earlier return to work. This calls into question the organization's ability to pass on savings from the reforms to employers. I know that State Fund's record for identifying fraudulent claims and reporting them to the Department lags far behind that of other insurers. This Department has received complaints indicating that some actions taken by State Fund may not be in compliance with the law or regulations.

IBM also noted that while other workers' compensation insurers in California receive regular discounts from top medical providers, State Fund in many instances has not done so—despite its advantageous bargaining position of holding more than 50% of the market. State Fund also acknowledged that employers using different brokers can call different State Fund offices and get different premium quotes on the same risk. IBM noted that State Fund lacked an adequate means of insuring consistency among its offices.

At present, I do not know whether State Fund has implemented IBM's recommendations. My staff is in the process of conducting an examination to determine the answer, as well as to report to the legislature on State Fund's ability to pass through the savings from the reform legislation, as we are required to do pursuant to SB 228. Assuming State Fund cooperates, I should be able to provide you with good information in my report.

I had initially hoped to use the expertise of Neal Conolly and his associates in performing this review of State Fund's operations. Mr. Conolly is a former head of the New York State Fund; in that role he was successful in overcoming many of the same challenges that California's State Fund currently faces. I believe that he is uniquely qualified to assist me in evaluating State Fund's operations and to provide suggestions for how to make improvements. Clearly, my July 1 report to the Legislature would have been more comprehensive had we been able to benefit from the services of Mr. Conolly.

Unfortunately, State Fund refused to permit Mr. Conolly to do this work. As a result, in March I instructed my legal staff to file suit against State Fund, asking the court to order it to permit Mr. Conolly's examination. The court did not decide this issue in time for Mr. Conolly to complete his work so that it could be included in my report to the Legislature and Governor; I have therefore dismissed the lawsuit against State Fund.

I continue to believe that these issues should not be decided through lawsuits. It is essential that the Department's role as State Fund's regulator be clarified, so that we are no longer forced to take legal action to effect regulation that could impact the State Fund. California will benefit greatly in the long run when my authority over State Fund is made clear, one way or the other.

How do we solve this problem? We have identified numerous issues that are pertinent and critical to the success of State Fund, and will have a significant impact on the well being of the economy of California. My effort was to work with State Fund to resolve these problems. My job, and the role of this Department, is to direct State Fund to develop corrective actions to resolve its financial and management difficulties, and to see that those actions are carried out. I have been thwarted in that effort. It is now up to the Legislature and the Governor to determine whether State Fund will act as an insurer and remain subject to this Department's authority, or whether it will become an unregulated entity.

Thank you